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Value of Franchise Rights Under BIG Tax: *H R B-Delaware v. Commissioner*

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A "small business corporation" that elects to be an S corporation is generally not subject to Federal income tax. Instead, the corporation's income "flows through" to its shareholders and is includible in computing their taxable incomes (Internal Revenue Code ("IRC") §§ 1363, 1366). However, if a corporation has not been an S corporation since the commencement of its corporate existence, but, rather, its election to be an S corporation ("S election") is made effective as of some later date, the electing corporation itself is subject to tax throughout a statutory "recognition period." The tax, imposed at the highest rate (currently 21%) applicable to corporations other than S corporations ("C corporations") on the corporation's "net recognized built-in gain" during any taxable year that begins within the recognition period, is often referred to as the "built-in gains," or "BIG," tax. For taxable years prior to 2009, the recognition period generally extended for 10 years from the effective date of the S election; it is now five years from that date (IRC § 1374).

The definition of an S corporation's "net recognized built-in gain" generally includes all gains and losses that are recognized by it during the recognition period upon its disposition of assets. However, the corporation may exclude gains (i) with respect to assets that the corporation did not own at the effective date of the S election and (ii) that are greater than the "built-in gain," that is, the excess of the fair market value over the adjusted basis of an asset, at that effective date. Because of this exclusion, if a C corporation makes an S election and then disposes of assets during the recognition period, disputes often arise with the Internal Revenue Service as to whether gain from that disposition is attributable in whole or in part to assets owned by the corporation at the time of the S election and, if so, as to the existence and extent of built-in gain, at the effective date of the S election, with respect to those disposed assets.

Built-in gain is commonly conceived as an amount to be quantified by valuation experts. However, in a recent order of the Tax Court addressing a motion for partial summary judgment, *H R B-Delaware, Inc. v. Commissioner*, Docket No. 28129-12 (January 29, 2019), the court concluded, without hearing expert testimony or conducting a trial, that franchise rights sold by an S corporation back to its franchisor for more than $100,000,000 in 2008 (a taxable year during the corporation's recognition period) had no value at the effective date of the corporation's S election approximately eight years before the sale.

This conclusion was reached notwithstanding that the franchise rights were previously valued by the corporation itself (in computing its BIG tax obligation on its 2008 return, as originally filed) as having been worth $11,900,000 on the effective date of the S election. The analysis in the decision underscores steps that are important to the evaluation of BIG tax exposure, and may also inform analysis in non-BIG tax contexts regarding the existence of goodwill or going concern value.

Facts in H R B-Delaware

In 1963, a franchise was granted by H & R Block ("H&R") to a Texas corporation that was a corporate predecessor of H R B-Delaware, Inc. ("H R B" or "the franchisee"). The franchise gave the franchisee the right to use H&R's name in connection with preparing income tax returns in Texas. The franchise agreement provided for an initial franchise fee and for the payment of annual royalties to H&R.

The agreement further provided that the franchise granted "was a personal and nonassignable license," and that, in the event of a breach by H&R of the agreement, the franchisee would be entitled to exclusive use of the H&R name in Texas. The term of the agreement was four years, "automatically renew[able] for successive periods of one (1) year each unless terminated by either party, as a result of a breach of this Agreement."

In the late 1990's, H&R began to make tax return preparation software widely available to individual customers. Franchisees, including H R B, sued

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H&R, asserting that the sale of such software was in breach of noncompetition provisions in the franchise agreements. H&R responded by asserting its right and intention to terminate each franchise agreement at the end of its stated current term. H&R argued that, under applicable Missouri state law (which disfavored contracts that would create rights or impose obligations in perpetuity), each franchise agreement would terminate at the end of its term if either party did not agree to renewal.

While the ensuing litigation was pending, H R B made an S election effective January 1, 2000. Later in the same year, H R B entered into a settlement with H&R. The settlement included an amendment to the franchise agreement that: (i) granted to the franchisee the right to assign its franchise rights to a third party subject to the approval of H&R, such approval not to be unreasonably withheld; (ii) struck the provision in the original agreement that provided the franchisee with the right to use H&R's name in the event of H&R's breach of the agreement; and (iii) added a stated finite term to the agreement, with H&R to have the right to buy out the franchisee at 10-year intervals at a price determined by formula.

In 2008, H&R bought the assets of the franchisee for more than $100,000,000. The franchisee's federal tax return for 2008 indicated that one of the assets of H R B at the time of its S election was franchise rights valued at $11,900,000. Taking that value into account, the return computed a BIG tax of almost $4,000,000.

The Service ultimately asserted that the franchise rights on the effective date of the S election had been worth $28,486,000 and determined that additional BIG tax was due. The franchisee filed a petition in Tax Court to seek review of that determination and then moved for summary judgment regarding the value of the franchise rights, requesting that the court determine that the franchise rights had no value. The order issued in response to the motion observed that if the franchise rights were worth nothing, the franchisee will probably be entitled to a tax refund.

The court agreed with the franchisee that. if the question of whether the franchise rights had any value on the S election date could be addressed on the basis of facts as to which there was no substantial controversy, that question would then be susceptible of determination in the context of a motion for summary judgment.

The order court then discussed and cited prior Tax Court cases concerning the transfer of car dealer franchise rights granted by an automobile manufacturer, and of analogous rights with respect to an automobile service station. *Akers v. Commissioner*, 6 T.C. 693 (1946), involved the liquidation of a corporation with a Cadillac franchise, where the business of the corporation was effectively continued with the consent of the franchisor by a successor partnership comprised of the shareholder of the corporation and his spouse. *Zorniger v. Commissioner*, 62 T.C. 435 (1974), involved an assertion of gift tax with respect to the transfer of stock of a corporation that held a Chevrolet franchise to the shareholder's son, also with the consent of the franchisor.

In both *Akers* and *Zorniger*, the car dealer franchises were not assignable and would terminate under various circumstances outside the control of the franchisee (for example, upon the death of the individual who controlled the franchisee). The cases concluded that, in those circumstances, no goodwill, going concern, or similar value existed that should be taken into account in the context of the termination or continuation of the franchise rights.

Another case cited in *H R B-Delaware* recognized the existence of goodwill in the context of terminable-at-will franchises, but was distinguished as involving the successful sale of the business to a third party without the involvement of the franchisor or equivalent third party in determining who would acquire the business. The court also rejected the Commissioner's attempt to limit the application of the car dealer franchise cases to situations involving the sale of tangible property rather than services.

The court in *H R B-Delaware* concluded that there was no meaningful difference between the car dealer franchise cases noted above and the circumstances before it involving a franchisee of H&R, and that the franchise rights granted to the franchisee accordingly could not have had any value that was recognized by the income tax law as of January 1, 2000.

Observations

The court order acknowledged the possibility that H R B had other intangible property, apart from its franchise rights, on the effective date of the S election. With respect to such other property, built-in gain may have existed on that date and may been triggered by reason of the buy-out of the franchisee in 2008. Thus, based on the limited facts set forth in the order, at least some BIG tax may ultimately be owed by the franchisee, notwithstanding its victory in the motion for summary judgment.

More generally, the order underscores the need, in the context of computing BIG tax liability of a corporation, to consider all facts and circumstances bearing on the identification of assets owned by the corporation at the time of the election and transferred in a later transaction, and on the value of each such asset on the relevant dates. The order also confirms the vitality of prior cases to the effect that, even where circumstances make clear that a business has a value in excess of its tangible assets, that value does not necessarily constitute or include transferable (and therefore at least potentially valuable) goodwill or going concern value; each situation must be evaluated on its particular facts.